

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

BIG RIVERS ELECTRIC CORPORATION'S)	
NOTICE OF CHANGES IN RATES AND)	
TARIFFS FOR WHOLESALE ELECTRIC)	CASE NO. 9613
SERVICE AND OF A FINANCIAL WORKOUT PLAN)	

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O R D E R

PREFACE

On August 7, 1986, Big Rivers Electric Corporation ("Big Rivers") filed an application with the Commission requesting authority to increase its rates for wholesale electric service rendered on and after September 6, 1986, based on a restructuring of its debts. The application states that the proposed rates would increase Big Rivers' annual revenues by approximately \$7.5 million, an increase of 3.58 percent over normalized revenues.

The Commission suspended the proposed rates until February 6, 1987, in order to conduct an investigation and hold public hearings on the reasonableness of the proposed rates. By agreement of the parties, in response to the Commission's request, the suspension period was extended to March 17, 1987. Motions for full intervention were filed by the Utility and Rate Intervention Division of the Office of the Attorney General ("Attorney General"), National Southwire Aluminum Company ("NSA"), Alcan Aluminum Corporation ("Alcan"), Utility Rate Cutters of Kentucky ("URCK"), Hancock County, Kentucky, City of Hawesville, Kentucky,

Willamette Industries, Inc. ("Willamette"), Commonwealth Aluminum Corporation ("Commonwealth"), and Alumax Aluminum Corporation ("Alumax"). Firestone Steel Products Company ("Firestone") moved for limited intervenor status. All motions to intervene were granted by the Commission.

Public hearings were held at the Commission's offices in Frankfort, Kentucky, commencing on December 2, 1986, and concluding on December 18, 1986. During the public comment portion of the hearing, statements were presented by Honorable Danny Boling, Hancock County Judge Executive, Thomas McCord, International Representative of Aluminum, Glass and Brick Workers International Union, Vicki Basham, Superintendent of Hancock County Schools, and Honorable Josephine Hagin, Mayor of Lewisport, Kentucky. Statements were also presented by counsel for Hancock County and Firestone. The parties sponsored testimony at the hearing by the following witnesses:

Big Rivers	William H. Thorpe - General Manager
	Paul A. Schmitz - Vice General Manager, Finance
	Joe Craig - Fuels Manager
	Ron Johnson - Vice General Manager, Corporate
	Services and Labor Relations
	Joseph Dolezal - Vice General Manager, Energy
	Supply
	Frederick L. McCoy - Ernst and Whinney
	Utility Group
	Herbert Vander Veen - Ernst and Whinney
	Utility Group
	Herbert F. Jacobs - Vice President, Manufacturers
	Hanover Trust Co.

Thomas B. Heath - Assistant to Deputy
Administrator, Rural Electrification Administration

Phillip B. Layfield - Ernst and Whinney

Paul H. Raab - Ernst and Whinney

Bernard L. Uffelman - Peat, Marwick, Mitchell
and Company

Douglas P. Sumner - Peat, Marwick, Mitchell
and Company

Robert F. McCullough - Manager of Regulatory
Finance at Portland General
Electric

John D. Hightower, Jr. - Southern Engineering Co.

Bernard J. Duroc-Danner - Arthur D. Little, Inc.

NSA

Howard W. Pifer, III - Putnam, Hayes & Bartlett, Inc.

Joseph S. Graves - Putnam, Hayes & Bartlett, Inc.

Allan J. Schultz - Casazza, Schultz & Associates

Roger M. Whelan - Verner, Hiipfert, Bernhard,
McPherson and Hand

Robert P. Matusiak - Director of Planning and
Analysis, National
Intergroup, Inc.

Kenneth T. Wise - Putnam, Hayes & Bartlett, Inc.

Alcan

Paul D. Belanger - Manager, Alcan Sebree Plant

Maurice Brubaker - Drazen-Brubaker Associates, Inc.

Christian K. Albrecht - Drazen-Brubaker Associates,
Inc.

H. Clyde Allen - Drazen-Brubaker Associates, Inc.

James A. Ross - Drazen-Brubaker Associates, Inc.

Stewart R. Spector - President, The Spector
Report, Inc.

NSA & Alcan

Sam F. Rhodes - Touche Ross & Co.

Attorney General Randall J. Falkenberg - Kennedy and Associates
Lane Kollen - Kennedy and Associates

Alumax and Charles F. Phillips, Jr. - Professor at
Commonwealth Washington and Lee University

Alumax Clyde M. Griggs - Manager, Alumax
Hawesville Rolling Mill

URCK David H. Kinloch - Consultant

Initial briefs were filed on January 21, 1987, and reply briefs on February 2, 1987. The Commission incorporated by reference and made a part of the record in this case Big Rivers' past two rate applications, Case No. 9006¹ and 9163,² and the D. B. Wilson Generating Station certificate proceeding, Case No. 7557.³

Big Rivers is a non-profit cooperative corporation engaged in the generation, transmission and sale of electricity, through four

¹ Case No. 9006, Big Rivers Electric Corporation's: (1) Notice of Change In Its Rates And Fuel Adjustment Clause Base For Electricity Sold To Member Cooperatives, and (2) Application For Authority To Issue Notes Or Other Evidences Of Indebtedness, and (3) Application For Approval Of Sale And Leaseback Of Its D.B. Wilson Station Generating Unit 1 And Associated Facilities.

² Case No. 9163, Big Rivers Electric Corporation's Notice Of Change In Its Rates For Electricity Sold To Member Cooperatives.

³ Case No. 7557, Application Of Big Rivers Electric Corporation For: (1) A Certificate Of Convenience And Necessity Under KRS 278.20 And 807 KAR 1:010, Section 7 And 8 To Construct And Operate The Following Facilities: (a) Two Additional Generating Units, Each Having A Net Rated Capability of 395 MW To Be Known As The "D.B. Wilson Generating Station" And To Be Located In Ohio County, Kentucky. (b) Any And All Appurtenant
(Footnote continued)

distribution cooperatives, to approximately 75,000 customers in 22 counties in Western Kentucky. Big Rivers derives approximately 70 percent of its member revenues from two industrial customers, NSA and Alcan, both engaged in the smelting of aluminum.⁴

BACKGROUND OF D. B. WILSON GENERATING STATION

Big Rivers' 1977 Power Requirements Study indicated that rural load would continue to increase at 9.97 percent through 1991 and industrial load would increase by 167 megawatts (MW) over the 1976 level of 665 MW. Total demand on the system was expected to be 1509 MW by 1986 and 1832 MW by 1991. With the two generating units at the Green Generating Station scheduled to be in service in 1979 and 1981, respectively, total plant capacity would be 1235 MW. This study predicted capacity shortages of 274 MW in 1986 and 597 MW in 1991 excluding any reserve capacity needed to maintain system reliability.⁵

In February 1978, Southern Engineering Company was employed by Big Rivers to determine its capacity needs and make expansion recommendations. The study was completed in 1979 and Southern

³(continued)

And Related Equipment And Facilities, (2) A Certificate Of Environmental Compatibility Under KRS 278.025 For The Facilities Described In Paragraph (1) Hereof. (3) Authority To Borrow From The United States Of America, Through The Rural Electrification Administration (REA), Or The Federal Financing Bank Or The Eligible Lender The Sum Of \$928,754,200 To Be Used For The Construction Of The Facilities As Further Described In The Application And Record.

⁴ \$82,654,460 from NSA plus \$60,908,446 from Alcan divided by \$208,296,183, total member revenue, Exhibit 4, page 2.

⁵ Big Rivers' Response to NSA's Second Request for Information, Item 264, pages 2-3.

recommended that two 395 MW steam electric generating units be added to the system, one in 1984 and the other in 1986.⁶ In June 1978, prior to completion of the study, Big Rivers requested a proposal from Burns and Roe to design a generating unit of approximately 350 MW to be scheduled for commercial operation in 1984. In December 1978, Big Rivers entered into a contract with Burns and Roe to design a 440 MW gross, 395 MW net, output rated unit. In May 1979, Big Rivers contracted with Westinghouse to purchase a turbine generator. The contract with Westinghouse gave Big Rivers 6 months to cancel before incurring any large cancellation penalties. Big Rivers stated that this provision was necessary to allow it adequate time to complete loan studies and make any necessary changes in the unit rating.⁷

On June 17, 1980, the Commission entered its Order in Case No. 7557, granting Big Rivers a Certificate of Public Convenience and Necessity to construct Wilson units 1 and 2. Shortly thereafter, Big Rivers began another comprehensive load forecast, the 1980 Power Requirements Study, which was completed in March 1981. The new forecast showed that load growth would increase at an annual rate of 3 percent, not the 9.97 percent predicted in the 1977 Power Requirements Study.⁸ Based on the results of this forecast Big Rivers' Board of Directors voted to suspend the

⁶ Ibid., page 4.

⁷ Thorpe Rebuttal Testimony, Volume I, pages 15-18.

⁸ Big Rivers' Response to NSA's Second Request for Information, Item 264, pages 6-7.

construction of the Wilson Unit No. 2 in April 1981, and ultimately cancelled it. Big Rivers subsequently decided to continue construction of Wilson Unit No. 1 ("Wilson") based on the potential increase in loads due primarily to the addition of a fourth potline by ARCO [predecessor of Alcan] and, an analysis indicating that the cost to delay commercial operation was approximately \$90 million per year.⁹

During 1982-83 aluminum prices took an unexpectedly deep and prolonged drop which led both aluminum smelters to shut down one of their potlines. The record reflects that during this period Big Rivers' Board of Directors and Rural Electrification Administration ("REA") representatives were regularly advised of Wilson's construction progress.¹⁰ By late 1983, aluminum prices rebounded and the smelters' load returned to normal.

In an attempt to reduce the rate impact from Wilson, Big Rivers attempted to execute a sale/leaseback (leveraged lease) of the Wilson Plant in 1984. The sale/leaseback arrangement with the General Electric Credit Corporation would purportedly have resulted in savings of approximately \$700 million over a 35-year period. The savings were to be attributable to provisions of the Internal Revenue Code which would have allowed the purchaser of the property to share tax benefits with Big Rivers resulting from accelerated depreciation, energy credits, and investment tax

⁹ Ibid., Item 264, page 7.

¹⁰ Ibid., page 9, and Rural Electrification Administration Field Activities Report of Mike Norman to Vincent Kaminski, dated October 9, 1982.

credits. Under this arrangement, Big Rivers' effective interest cost would have been lowered from an estimated 11.5 percent to 7.9 percent.¹¹ This was expected to save ratepayers \$700 million over the plant's life.¹² However, Big Rivers was unable to resolve a number of major points and the sale/leaseback was abandoned.

In April 1984, Big Rivers filed a rate application, Case No. 9006, requesting additional revenue of \$48 million under the scenario of a sale/leaseback for Wilson or, alternatively, \$57.6 million without a sale/leaseback. Due to Big Rivers' financial inability to consummate the sale/leaseback and strong opposition to the rate increase voiced by NSA and Alcan, the application was voluntarily withdrawn.¹³ Aluminum prices again sharply declined in 1984 and Big Rivers took the position that higher rates could result in the shutdown of the smelters.¹⁴

In November, 1984, Big Rivers filed another rate application, Case No. 9163, requesting a \$16.7 million increase in rates. Big Rivers did not seek to recover any of the costs associated with Wilson except those related to two high voltage transmission lines tying Wilson into Big Rivers' system.¹⁵ Mr. Thorpe testified that the Wilson costs were excluded in that case because Big Rivers

¹¹ Case No. 9006, Big Rivers' Application.

¹² Big Rivers' Response to NSA's Second Request for Information, Item 264, page 9-10.

¹³ Case No. 9163, Order issued May 6, 1985, page 3.

¹⁴ Big Rivers' Response to NSA's Second Request for Information, Item 264, page 10.

¹⁵ Case No. 9163, Order issued May 6, 1985, page 1.

recognized that: (1) no economically viable solution had been reached to solve its financial problems; and (2) NSA and Alcan might go out of business if their rates increased.¹⁶

In November 1984, REA refused to advance any additional committed loan funds to Big Rivers. According to Big Rivers this rendered the utility incapable of using loan funds to pay the contractors for work completed at the Wilson Plant. Big Rivers subsequently filed suit against REA to release the committed loan funds.¹⁷ In order to complete construction of Wilson, Big Rivers used internally generated funds and suspended its loan payments to REA. Big Rivers contended that having an income-producing asset was preferable to abandoning that asset and writing off approximately \$700 million.¹⁸

On January 3, 1985, REA notified Big Rivers that it was in default on loan payments as of November 23, 1984, and asked for full payment of indebtedness of approximately \$1.1 billion.¹⁹ On January 18, 1985, the Justice Department, acting on REA's behalf, filed a foreclosure action against Big Rivers in the U.S. District Court, Western District of Kentucky.²⁰

¹⁶ Thorpe Direct Prepared Testimony, pages 6-7.

¹⁷ Big Rivers v. Harold Hunter, Administrator of the Rural Electrification Administration, Civil Action No. 84-0317-O(J), U.S. District Court (W.D. KY.)

¹⁸ Big Rivers' Response to NSA's Second Request for Information, Item 264, pages 12-13.

¹⁹ Ibid., page 13.

²⁰ United States of America v. Big Rivers Electric Corporation, Civil Action No. C85-0012-O(J), U.S. District Court (W.D.KY.).

By Order entered May 6, 1985, the Commission denied Big Rivers' proposed rate increase, recognized that a financially viable solution for Wilson costs would need to be developed, and directed Big Rivers to negotiate with NSA and Alcan to develop flexible power rates that would reflect the market price of aluminum.

In early August, 1986, Big Rivers negotiated a Debt Restructuring Agreement (workout plan) with its creditors in an attempt to solve its financial problems and resolve the pending litigation with REA.²¹

REVENUE INCREASE

Big Rivers' rate application states that the proposed rates will increase annual revenues by \$7,452,524 or 3.58 percent based on a 1985 test year.²² In calculating this revenue increase, however, Big Rivers offset the proposed increase by a \$15,462,514 reduction in its fuel expense.²³ This significant reduction in fuel expense was achieved in 1986 by renegotiating existing coal contracts and executing new, lower cost coal contracts. While Big Rivers should be commended for taking the initiative to reduce its largest operating expense, the Commission is concerned that Big Rivers' rate application does not accurately reflect the magnitude

²¹ Big Rivers' Response to NSA's Second Request for Information, Item 264, page 15.

²² Application, Exhibit 4, page 1.

²³ The \$15,462,514 consists of a \$12,635,946 reduction in Fuel Adjustment Clause expense and a \$2,826,568 reduction in base fuel revenue. See Application, Exhibit 5, page 1, Pro Forma Adjustments.

of the proposed rate increase. All of these savings from reductions in coal costs are required to be flowed back to the ratepayers through the prior reduction of base rates under fuel adjustment clause regulation, 807 KAR 5:056. The ratepayers have and will continue to benefit from these reduced fuel expenses independently of this rate case.²⁴ Consequently, the offsetting of a proposed increase in rates by a required decrease in fuel revenue is misleading and impermissible. Once the fuel revenue is disregarded, as it must be, Big Rivers' rate application actually seeks a \$22,915,038 or 11 percent annual revenue increase.²⁵ Further, the workout plan requires additional rate increases in 1989 and 1991.²⁶

NSA COMPLAINT

On October 2, 1985, NSA filed a formal complaint against Big Rivers, Case No. 9437, National-Southwire Aluminum Company v. Big Rivers, requesting a reduction in the rates that had been approved by the Commission on May 6, 1985, in Case No. 9163.

The complaint states two grounds in support of reduced rates: (1) revenues from a 54 megawatt off-system sale to the Municipal Energy Agency of Mississippi ("MEAM"), which had been excluded for rate-making purposes in Case No. 9163 and attributed to the Wilson Plant, should now be considered for rate-making purposes because

²⁴ Hearing Transcript, Volume II, pages 33-34.

²⁵ \$7,452,524 plus \$15,462,514 divided by 1985 actual revenues of \$208,296,183 as shown on application, Exhibit 4, page 2.

²⁶ Big Rivers' Response to NSA's Second Request for Information, Item 281, page 9.

Big Rivers has the generating capacity to accommodate that sale; and (2) Big Rivers' failure to reduce its per-ton cost of coal by either renegotiating existing contracts or filing bankruptcy to void the contracts. NSA requested that any rate reduction granted be first applied to reduce NSA's rate from approximately 28 mills to 22 mills due to: (1) its need for a 22 mill rate to insure its continued financial viability; (2) its prior subsidization of Alcan and its predecessors resulting from Big Rivers' 1981 rate increases to include the costs of the Green 2 generating unit constructed to serve Alcan's predecessors; and (3) the willingness of NSA's corporate parents to guarantee performance by NSA of its long term power supply contract.

NSA subsequently amended its complaint to allege that while Big Rivers has been collecting rates that were designed to recover the debt service requirement for its system excluding Wilson, little if any debt service payment has been made. An investigation was sought into the "diversion of revenues intended for debt service to other undisclosed purposes...."²⁷ A Second Amended Complaint was filed by NSA to delete its request for a 22 mill preferential rate and seek reduced rates for all customers. After a period of extensive discovery and the filing of prepared testimony, NSA's complaint was consolidated with Big Rivers' rate application by Commission Order entered August 14, 1986. The consolidation was pursuant to a motion by Big Rivers filed on August 7, 1986, in Case No. 9437.

²⁷ NSA Amended Complaint, page 5.

NSA MOTIONS TO DISMISS

NSA filed a motion and a supplement thereto to dismiss Big Rivers' rate application on multiple grounds attacking the merits of the workout plan. Big Rivers opposed NSA's motions and stated that the issues were more appropriate for resolution in the rate case hearing.

By Order entered September 16, 1986, the Commission held the motions in abeyance, finding that they raised substantial issues of fact not readily determinable prior to the scheduled evidentiary hearing. Based on the Commission's findings on the workout plan, set forth in detail below, NSA's motions are rendered moot and should be denied.

COMMISSION CONCERNS

This case presents some of the most difficult and momentous issues ever considered by this Commission. Despite all parties' appeal to traditional rate-making principles, this is clearly no ordinary rate case. The repercussions of our decision on the economic life of Western Kentucky have weighed heavily in our deliberations in this case.

The uneven load distribution of the Big Rivers system is an inescapable fact that is deeply disturbing to us. Nearly seventy percent of Big Rivers' member revenues comes from two aluminum smelters: NSA and Alcan. This overwhelming dependence on two huge customers creates a tremendous risk for the utility. If the aluminum industry goes sour, the result for Big Rivers and its 75,000 customers will be catastrophic. When the aluminum industry entered a deep recession beginning in 1983, Big Rivers found

itself in a nightmarish position. To add to its misery, the utility's remaining load growth had leveled off, the prospect of a synthetic fuels industry had evaporated, and the \$900 million Wilson Unit No. 1 was nearly completed. Big Rivers was paying the price for being basically a one-industry utility.

The Commission's awareness of this problem was an important element in establishing our statewide planning docket.²⁸ In that docket we are examining, among other things, the long-term prospects of sharing capacity among the state's electric utilities, rather than permitting utilities to continue the traditional practice of adding new capacity based primarily on forecasts of their internal loads. That docket offers hope that Big Rivers' one-industry problem can be mitigated in the long run.

In the near term, if Big Rivers, its creditors, and customers can agree on a plan to stabilize the utility, it is incumbent on both the public and private sectors to immediately begin seeking new industries to locate in Big Rivers' territory and encouraging existing employers to expand. This is an important first step in the long and difficult process of diversifying the utility's load. But in the current climate, this step is difficult if not impossible. It is to this climate of uncertainty that we now turn.

The financial condition of the aluminum smelters is a matter of controversy in this case. Of significant importance is the

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Administrative Case No. 308, An Inquiry Into Kentucky's Present And Future Electric Needs And The Alternatives For Meeting Those Needs.

issue raised by Big Rivers that its proposed rates are competitive rates for aluminum smelters. The Commission ruled at the hearing that it would not consider evidence on the costs and profitability of particular smelters, although it would consider evidence on the economic conditions of the aluminum industry in general.²⁹ We find it difficult to evaluate the arguments and counter-arguments on this issue. An aluminum company is in a vastly different position than a regulated utility. There is no monopoly franchise and no obligation to serve. Even a relatively profitable plant can be closed if its owner decides that other considerations outweigh its continued operation. One such consideration is uncertainty about the cost of its major raw material: electricity.

It is important to note four points that have emerged from the thousands of pages of testimony in this proceeding:

- The aluminum industry has made a major investment in Western Kentucky and would like that investment to succeed.
- If the uncertainty can be lifted from the Big Rivers system and some reasonable compromise reached among all parties, then there is still hope that the aluminum industry will decide to stay, and perhaps even grow.
- If the aluminum industry leaves, the chances of the Big Rivers' creditors ever recouping their investment dramatically decline.

²⁹ Hearing Transcript, Volume I, page 116.

• Wilson is not a half-finished nuclear station. It is a revenue-producing, state-of-the-art coal-fired unit that may be capable in the long run of producing enough revenue as part of the Big Rivers system to repay a substantial portion or possibly all of the creditors' investment.

COMMISSION CONCLUSIONS

With this as background, the Commission has reached the following conclusions:

The overriding issue in this case is the workout plan, not a proposed rate increase. The workout plan as it now stands is filled with unrealistic assumptions and unspecified targets. The Commission is disappointed with the bargaining position taken by Big Rivers in the negotiations with its creditors. After meeting with the REA and being advised that the REA's policy was no bailouts under any circumstances,³⁰ Big Rivers attempted to negotiate a workout plan to insure the repayment to REA and the banks of all outstanding principal and interest. The workout plan was thus achieved by merely deferring present financial obligations to future periods and thereby committing Big Rivers' ratepayers to two projected rate increases, in 1989 and 1991, and an indeterminable number thereafter.

Rather than provide a workable solution, the plan would intensify the climate of uncertainty. The result would very likely be a severe erosion in the economic base -- including the aluminum industry -- that supports the Big Rivers system. This

³⁰ Hearing Transcript, Volume I, page 148.

would be a disastrous result not only for Big Rivers and its customers, but also for its creditors.

Since our approval of this rate increase would trigger the operation of the workout plan, we reject the rate increase as unreasonable. We will not be drawn inch by inch into approving so important a workout plan. In reviewing any future workout plan, we will likewise vigorously assert our statutory right and responsibility to examine and approve the complete proposal, including all assumptions and supporting data. In so doing, the Commission will seek to insure that the interests of all parties are balanced and that the interests of all classes of Big Rivers' ratepayers are preserved. There is a heavy burden of responsibility on the primary negotiators of the workout plan to incorporate those interests in a workable solution.

We are today on our own motion establishing an investigation into the reasonableness of the rates of Big Rivers. In this case we are ordering Big Rivers to conduct over the next four months a series of negotiations aimed at reaching an acceptable solution to this problem. First, Big Rivers will seek to negotiate a revised workout plan with its creditors similar to the one approved by the REA in the Sunflower Electric Cooperative case. Next, Big Rivers will begin meeting with the aluminum companies to negotiate a flexible rate plan that recognizes both the cyclical nature of the aluminum industry and the needs of the utility. The Commission is interested in the results of these negotiations even if agreement can be reached with only one aluminum company. Finally, Big Rivers is to meet with the Attorney General and other interested

parties to explain the negotiations and discuss how the interests of the non-aluminum customers are being protected. We strongly urge all participants to enter these discussions promptly and in a spirit of good faith. If the participants deem it helpful, the Commission will offer its assistance in facilitating the discussions. We would hope that one outcome of these negotiations would be the settlement of all pending civil litigation.

If the participants cannot agree on an acceptable workout plan and associated flexible rate plan in the next four months, the Commission will move quickly thereafter to set just and reasonable rates for Big Rivers. The evidentiary record on which these rates will be set will include the record in this case, which will be incorporated by reference into Case No. 9885, An Investigation Of Big Rivers Electric Corporation's Rates For Wholesale Electric Service.

We do not accept NSA's contention that Big Rivers' customers are entitled to a rate decrease because the utility has commingled assets of the existing system and the Wilson system. In this case, we decline to cut the Big Rivers system in two. The Commission finds that the expenditure of funds to complete Wilson was in the discretion of Big Rivers' management. Therefore, that aspect of NSA's complaint is denied. The issue of the allocation of off-system sales remains before the Commission in its investigation of Big Rivers' rates. In the further negotiations, all the participants should focus on the potential cash flow of the entire Big Rivers system under a revised workout plan and how that will affect the fairness of rates to Big Rivers' customers.

We emphatically reject the claim of REA, the banks, and Big Rivers that the members of the cooperative ultimately bear the total risk and responsibility for the utility's debts. The distribution cooperatives and their members do not stand in the same position as shareholders of an investor-owned company. The REA, with its oversight and monitoring responsibility, bears a substantial amount of the risk associated with Big Rivers' actions. The creditor banks are compensated for the risks they take. Cooperative members must shoulder a portion of the risk, too, since they have a say in the affairs of the utility. Nor are the aluminum companies exempt from responsibility. Until the downturn of recent years, these companies or their predecessors were in frequent contact with Big Rivers' management. Rather than allocate the risk among all parties now, we have chosen to give the participants an opportunity to discuss the allocation among themselves as a revised workout plan is negotiated.

ISSUES

Commission Jurisdiction Over Workout Plan

Big Rivers has not sought Commission approval of the workout plan itself. Approval is being sought only for the proposed rates which are based on the workout plan. However, the workout plan will directly impact Big Rivers' financial stability. Since the proposed rates will produce revenues less than Big Rivers' full cost of service, they can only be found to meet the statutory criteria of fair, just, and reasonable if the workout plan itself is economically feasible and reasonable. Consequently, the Commission cannot accede to Big Rivers' request that the proposed

rates be reviewed in a vacuum. The Commission concludes that Big Rivers and its creditors expect that an Order approving the proposed rates and activating the workout plan will equitably bind the Commission to all the plan's provisions. It is for these reasons that the Commission is compelled to review the economic feasibility of the workout plan at this time.

Workout Plan

Big Rivers, in an effort to resolve its financial problems, has negotiated a workout plan with its creditors. The plan, as filed on August 13, 1986, has four key elements:

1. Debt deferral.
2. Interest rate reduction.
3. Additional funds loaned by the banks to reduce high interest government debt.
4. Settlement of REA's foreclosure suit against Big Rivers.³¹

The workout plan is conditioned upon Big Rivers' submission of this rate case requesting authority to increase capacity charges to \$7.50 per KW, to modify billing demand to provide for a peak demand ratchet, to restructure its debt as provided in the plan, and to limit annual capital expenditures to specified levels.³² Additionally, the plan provides that if the Commission approves the rate proposal as submitted, the REA and the banks

³¹ Schmitz Direct Prepared Testimony, page 4.

³² Big Rivers Debt Restructuring, July 21, 1986, Section A, (Revised July 29, 1986.)

will attempt to agree on future financial and other relevant targets which Big Rivers must attain.³³

After an affirmative decision by the Commission with respect to the rate case and an agreement by the creditors on the targets, the workout plan further provides that the REA will withdraw its foreclosure action. In addition, the interest rate on Big Rivers' arrearage to the federal government ("government arrearage") will be reduced to 8 percent from a composite rate of 10.33 percent and additional debt restructuring will occur.³⁴ Further, the banks will loan Big Rivers \$24 million.³⁵

As a result of the additional debt restructuring, Big Rivers will begin paying the accrued as well as current interest on interest drawings, purchase price drawings and principal drawings associated with pollution control bonds.³⁶ Cash flow in excess of the amount necessary to pay operating expenses and the obligations to the banks will be used to pay interest and principal on, first, REA debt, Federal Financing Bank ("FFB") debt and then government arrearage debt. If cash flow is insufficient, REA will advance Big Rivers sufficient funds ("shortfall debt") to service the FFB debt. The shortfall debt will accrue interest at rates matching the FFB obligations and will have various maturities. The

³³ *Ibid.*, Section C.

³⁴ Big Rivers' Response to NSA's Second Request for Information, Item 96, page 1.

³⁵ Schmitz Direct Prepared Testimony, pages 6-7.

³⁶ *Ibid.*, page 7.

government arrearage debt will convert to 30-year, 8 percent mortgage debt when cash flow is sufficient.³⁷ The amount due on pollution control bonds will be amortized following payment of the government arrearage debt and the unsecured arrearages.³⁸ Finally, neither the REA nor the banks will be obligated to proceed if Big Rivers does not meet its targets, if an affirmative rate decision is not sustained or is unfavorably modified,³⁹ or if the Commission does not approve the rate case as submitted.⁴⁰

According to Big Rivers,

The central idea behind the restructuring plan is that all of Big Rivers' cash flow beyond that needed for operating expenses and minimal capital improvements will be used to service Big Rivers' debt. In return, the creditors will defer sufficient debt to enable Big Rivers to add the D.B. Wilson plant to its system without causing "rate shock" to its customers and without increasing rates to the aluminum smelters over 1985 levels. In addition, should Big Rivers not achieve its sales targets and consequently be unable to fully meet payments scheduled in the debt restructuring plan, the creditors will further defer those amounts.⁴¹

Big Rivers stated in its application that the proposed rates are the initial step in the workout plan. Mr. Thorpe stated that the proposed rates are below the full cost-of-service⁴² and Mr. Schmitz stated that without the workout plan demand rates would be

37 Big Rivers Debt Restructuring, Section D(6).

38 Ibid., Section D(7).

39 Ibid., Section D(9).

40 Ibid., Section C.

41 Schmitz Direct Prepared Testimony, page 8.

42 Thorpe Direct Prepared Testimony, page 12.

\$10.75 rather than the proposed \$7.50 to meet the cost-of-service.⁴³ Mr. Jacobs of Manufacturers Hanover and Mr. Heath of the REA submitted rebuttal testimony and presented oral testimony at the public hearing on behalf of Big Rivers in support of the workout plan.

It is the position of the intervenors that the workout plan is neither a long-range solution to Big Rivers' financial problems nor in the best interests of Big Rivers' consumers. The issues arising from the plan with which the intervenors take exception are:

1. Future financial targets.
2. Off-system sales levels.
3. Future rate increases.
4. Allocation of risk.

Future Financial Targets

Both NSA and Alcan maintain that the workout plan lacks specificity in that the plan provides that Big Rivers must attain financial targets to be determined by the creditors after a favorable Commission decision on the rate case as submitted.⁴⁴ Upon cross-examination, Mr. Thorpe testified that he had no idea whether any targets were being discussed, that he thought all the targets were included in the plan, and that he was unaware of other targets.⁴⁵

⁴³ Schmitz Direct Prepared Testimony, page 9.

⁴⁴ Big Rivers Debt Restructuring, Section C.

⁴⁵ Hearing Transcript, Volume I, page 191.

With respect to the targets, Mr. Jacobs testified that measures of cash flow and the level of off-system sales were items to be considered, but the most important consideration was cash flow.⁴⁶ Mr. Heath testified that the concept of targets was included in the workout plan as an attempt to assure its long-term viability, recognizing that there will be changes in the future, such as the level of sales.⁴⁷

In summary, Big Rivers and the creditors maintain that the plan recognizes the need for flexibility. The intervenors, however, maintain that since the creditors will not be obligated to proceed if Big Rivers fails to attain the unspecified targets, the workout plan lacks information sufficient for evaluation.

Off-System Sales and Future Rate Increases

In addition to future targets, the intervenors challenged the feasibility of the workout plan based upon the financial projections submitted by Big Rivers as support for the reasonableness of the plan. Those projections are contained in Item No. 281, Big Rivers' response to NSA's Second Information Request.

Sam F. Rhodes, testifying at the public hearing on behalf of NSA and Alcan, enumerated the key assumptions incorporated in Item No. 281 and described them as extremely optimistic.⁴⁸ According to the intervenors, the elements of Item No. 281 which render the

⁴⁶ Ibid., Volume IX, page 119.

⁴⁷ Ibid., Volume VIII, page 159.

⁴⁸ Ibid., Volume VII, page 133.

workout plan questionable are the amount of off-system sales and future revenue increases.

The amount of off-system sales incorporated in the workout plan includes continuing firm sales to MEAM and future firm sales of 200 MW to unspecified parties. Mr. Rhodes testified that, based on historical results, it is not reasonable to assume that Big Rivers can achieve the forecasted level of off-system sales.⁴⁹ In 1988 and 1991, Big Rivers has projected off-system sales of 4,947,085 MWH and 4,919,141 MWH,⁵⁰ respectively. The actual annual off-system sales for the past 4 years have averaged 2,547,947 MWH.⁵¹ Mr. Rhodes further testified that based on his understanding of the workout plan, shortfall debt arising from Big Rivers' inability to achieve the projected off-system sales would increase to a level of from half a billion to three-quarters of a billion dollars. He stated that given the abundant supplies of electricity in the region, Big Rivers should have been conservative in projecting the amount of off-system sales.⁵²

In his testimony on behalf of Big Rivers, Bernard Uffelman stated that, based on corrected financial projections, Mr. Rhodes had overstated shortfall debt by approximately \$300 to \$331

⁴⁹ Rhodes Prefiled Testimony, page 13.

⁵⁰ Big Rivers' Response to NSA's Second Request for Information, Item No. 281, page 6.

⁵¹ Rhodes Prefiled Testimony, Schedule 10.

⁵² Hearing Transcript, Volume VII, page 155.

million.⁵³ Mr. Heath, testifying with regard to the prudence and reasonableness of the projections, stated that the assumptions were cautiously chosen and that REA believes that a sales level greater than projected could be achieved.⁵⁴ Mr. Heath further testified that REA's own projections were "representative of" the conclusions shown by Big Rivers in Item No. 281.⁵⁵ Mr. Jacobs agreed that the forecasts were reasonable and prudently made.⁵⁶

Upon cross-examination Mr. Thorpe testified that:

It's going to be difficult to make the \$90 million something sales that we projected. Of course, a fear that we had at the time that we filed the case, we'd rather be on the high side than on the low side because the staff may increase the sales and reduce the rates. So, if we do not reach the projected sales that we have, it's going to be more of a shortfall on the part of the creditors, which they've agreed to pick up, so it's not going to affect Big Rivers' financial condition any more than it already is.⁵⁷

Mr. Schmitz testified that Big Rivers' projections were optimistic but were made in order to avoid an argument as to the appropriate level of off-system sales.⁵⁸ Further, Mr. Heath testified that the market for power is now a buyer's market and that REA views

⁵³ Uffelman Rebuttal Testimony, page 9.

⁵⁴ Hearing Transcript, Volume VIII, page 178.

⁵⁵ Ibid., page 186.

⁵⁶ Ibid., Volume IX, page 127.

⁵⁷ Ibid., Volume I, pages 237-238.

⁵⁸ Ibid., Volume II, page 161.

the market as being "a little more favorable" to the seller in 5 years.⁵⁹

The intervenors further maintain that this proceeding is the first step to including all of Wilson in the rate base. In support of this position NSA and Alcan cited the fact that the cash flow projections in Item No. 281 include all Wilson operating costs and project rate increases in 1989 and 1991.⁶⁰

Mr. Thorpe stated that if the Commission approves the rates in this case, this does not guarantee Commission approval of rate cases to be filed in the future.⁶¹ However, Mr. Thorpe testified that if the projections are accurate Big Rivers will seek rate relief in 1989 and 1991. Further, Mr. Thorpe testified that the pro forma test year expenses include all Wilson expenses except for the amount being deferred under the workout plan.⁶²

Allocation of Risk

In addition to unspecified future targets and unreasonable financial projections, the intervenors maintain that the workout plan unfairly imposes the risk of loss on the ratepayers and not on the creditors.

Mr. McCoy and Mr. Heath both testified on behalf of Big Rivers that the ratepayers, as the owners of Big Rivers, should

⁵⁹ Ibid., Volume IX, pages 11-12.

⁶⁰ NSA's Initial Brief, pages 62-63, Hearing Transcript, pages 54-55.

⁶¹ Ibid., page 126.

⁶² Ibid., page 241.

pay for Wilson even if it represents excess capacity. Mr. McCoy stated that the ratepayers of a rural electric cooperative are the owners and are in a similar position to shareholders; therefore, costs cannot be shifted from one group to another.⁶³ Thus, according to Mr. McCoy, the used and useful standard, a method for allocating risk between shareholders and ratepayers, is not applicable in this case.⁶⁴ Mr. Heath testified that the debt related to Wilson was part of Big Rivers' "entire legitimate indebtedness" and should be repaid by the members of the cooperative.⁶⁵

Mr. Schmitz testified that Big Rivers did not seek forgiveness of debt.⁶⁶ However, he did state that the creditors are at risk for any shortfall debt that may accrue because the Commission may not approve future rates to recover the shortfall debt as included in the financial projections.⁶⁷ Mr. Heath, when addressing the concept of targets, concurred with Mr. Schmitz regarding the extent of the creditors' risk.⁶⁸ Finally, Mr. Thorpe testified that the workout plan was not a solution benefiting the creditors which was thrust upon Big Rivers, pointing out that the creditors had agreed to defer any shortfall and

⁶³ Ibid., Volume III, page 68.

⁶⁴ Ibid.

⁶⁵ Ibid., Volume IX, pages 47-48, 83.

⁶⁶ Ibid., Volume II, page 91.

⁶⁷ Ibid., Volume II, page 168.

⁶⁸ Ibid., Volume IX, page 77.

that the banks will make an additional loan of \$24 million to Big Rivers.⁶⁹ Further, Big Rivers argues in its initial brief that the interest reduction is, in effect, a writedown of debt.⁷⁰

The intervenors, however, maintain that all the risk has been placed on the ratepayers in that the creditors will ultimately be repaid their entire debt with interest.⁷¹ Alcan argues in its reply brief that, "REA and creditor control over Big Rivers will be enhanced, while this Commission's ability to effectively regulate will be hamstrung by the yet-to-be-disclosed targets."⁷²

Dr. Charles F. Phillips, on behalf of Commonwealth and Alumax, testified extensively with regard to the allocation of risk. Dr. Phillips pointed out that the workout plan was not a true restructuring of debt in that there was no writedown.⁷³ Dr. Phillips further stated that Big Rivers' ratepayers were not analogous to shareholders because if they live in a cooperative's service area they must become members of the cooperative in order to receive electric service. Finally, Dr. Phillips testified that the creditors and not the Commission were obligated to rescue a company from poor decisions.⁷⁴

⁶⁹ Thorpe Rebuttal Testimony, pages 2-4.

⁷⁰ Big Rivers' Initial Brief, page 101.

⁷¹ NSA's Initial Brief, page 60.

⁷² Alcan's Reply Brief, page 8.

⁷³ Hearing Transcript, Volume VIII, page 29.

⁷⁴ Ibid., page 49.

Upon cross-examination, Mr. McCoy admitted that Big Rivers' ratepayers, unlike shareholders in an investor-owned utility, could not vote their stock in proportion to their economic interest⁷⁵ nor could they sell their stock if they disagreed with management decisions.⁷⁶ Although NSA and Alcan provide approximately 70 percent of Big Rivers' member revenues, each has only one vote "the same as any other customer has."⁷⁷

Sunflower Debt Restructure Plan

During the course of this proceeding, other cooperatives with financial problems were referenced. Chief among those was Sunflower Electric Cooperative, Inc., ("Sunflower") of Hays, Kansas. A copy of Sunflower's workout plan was submitted by REA on December 19, 1986. Sunflower's plan, unlike that of Big Rivers, is not contingent upon regulatory approval of a rate increase and does incorporate the possibility of the forgiveness of principal.

In this case, the intervenors argued that Big Rivers should have sought forgiveness of a portion of principal and maintained that a rate increase would be harmful to the ratepayers, especially the aluminum smelters. Mr. Thorpe stated that Big Rivers was informed early in the negotiations that there was no possibility of a write-off.⁷⁸ Mr. Heath stated that REA expects no write-off

⁷⁵ Ibid., Volume III, page 97.

⁷⁶ Ibid., page 102.

⁷⁷ Ibid., Volume VIII, page 68-69.

⁷⁸ Ibid., Volume I, page 148.

under the Sunflower plan⁷⁹ and that REA does not deal in grants.⁸⁰ Big Rivers further argues that the smelters can afford this rate increase⁸¹ and that the creditors felt the increase should be greater.⁸²

The Commission is of the opinion that the speculative nature of the provisions regarding off-system sales, future rate increases, and financial targets clearly tips the balance of the present agreement in favor of the creditors. In contrast to Big Rivers' workout plan is the Sunflower plan which is not contingent upon an immediate rate increase, speculative off-system sales, or unspecified future targets. In addition, the Sunflower workout plan incorporates the possibility that debt may be written off in the future.

When cross-examined by NSA's counsel regarding the possible write-off of debt, Mr. Heath stated that there were more dissimilarities than similarities between Big Rivers and Sunflower due to Sunflower's past "efforts in rate remedies and their present rate structure."⁸³ The Commission cannot concur with Mr. Heath's assessment of the situation. Sunflower is a financially troubled cooperative that has attempted to remedy its problems through rate increases. Its rates are presently more than double those of Big

⁷⁹ *Ibid.*, Volume VIII, page 204.

⁸⁰ *Ibid.*, Volume IX, page 53.

⁸¹ Big Rivers' Reply Brief, page 5.

⁸² Jacobs Rebuttal Testimony, pages 7-8.

⁸³ Hearing Transcript, Volume VIII, pages 205-206.

Rivers.⁸⁴ Both Big Rivers and Sunflower have unique characteristics. Nevertheless there are striking similarities between the two.

Like Sunflower, the ability of Big Rivers' ratepayers to bear an increase is questionable, but for different reasons. Big Rivers is unique in that approximately 70 percent of its member revenues is derived from the aluminum industry which is in an economically depressed condition. Further, the collapse of the aluminum companies would have a devastating affect on the economy of Western Kentucky. Therefore to compare the rate levels and rate structure of Big Rivers and Sunflower is inappropriate.

The Commission is not endorsing the Sunflower plan in its entirety. The Commission, however, notes that the Sunflower plan, by not requiring immediate rate increases and not guaranteeing full recovery of debt, presents a more equitable balancing of interests. Further, the severe economic condition of the aluminum industry and Big Rivers' unique load configuration place Big Rivers in a financial position similar to that which nearly led to Sunflower's collapse.

Prudency

NSA and Alcan have raised the question of whether Big Rivers' decision to build Wilson and complete it in 1984 was prudent. Their concerns relate primarily to two points. First, Big Rivers relied heavily on a Southern Engineering Company study entitled "Power Cost Study" to determine the capacity of the planned

⁸⁴ Ibid., page 204.

generating unit. Secondly, they questioned Big Rivers' decision in 1981 to continue with the construction of Wilson in light of reduced demand. In its analysis, Alcan concluded that 39 percent of the Big Rivers' Wilson investment should be excluded from rates. On the other hand, NSA determined that the entire investment should be excluded.

H. Clyde Allen, witness for Alcan, testified that the Southern Engineering study, which was the basis for the decision to build the 395 MW Wilson unit, relied on another study by Black and Veatch entitled "Report on Power Supply Reliability". The Black and Veatch study computed reserve requirements for "varying sizes of additions" to the Big Rivers system.⁸⁵ The study showed that, "based on the loads for 1985 forecast in the 1977 Power Requirements Study, (1,450 MW), if 200-MW units are added, a reserve margin of 16.4 percent would be needed and an additional 400 MW (two units) would be needed. On the other hand, if 400-MW units were to be installed, a reserve margin of 42.5 percent would be required and 780 MW (two units) would be needed."⁸⁶ Southern Engineering, using a similar reliability criterion, found that "if 200-MW units are added, a reserve of about 20 percent is appropriate, whereas if 400-MW units are added, a reserve of approximately 50 percent is appropriate."⁸⁷ The concern raised by Mr. Allen was that both studies initially show similar reliability

⁸⁵ Allen's Prefiled Testimony, page 4.

⁸⁶ Ibid.

⁸⁷ Ibid., page 5.

problems with 400 MW units, yet the final plan adopted by Big Rivers called for the installation of only 400 MW units.⁸⁸ Mr. Allen testified that Southern Engineering, after evaluating several alternatives, revised its report and recommended "an expansion plan based on installing 395 MW coal-fired steam plants."⁸⁹ It is Mr. Allen's opinion that given the superiority of the expansion plan based on installing 210 MW units "from a cost standpoint, a reliability standpoint and a flexibility standpoint," he "would have rejected the consultants' recommendation."⁹⁰ Maurice Brubaker, witness for Alcan, testified that since Big Rivers was imprudent, approximately 39 percent of the Wilson investment should be excluded from rates.⁹¹

In response, Mr. Thorpe testified that the final decision to build the 400 MW Wilson units was not a simple one but involved a complex planning process which lasted from 1977 to 1980.⁹² He further stated that during this period there were public hearings before the Commission and, in addition, REA was involved in an ongoing review of the decision making process of Big Rivers.⁹³

Dr. Howard W. Pifer, III, witness for NSA, testified that Big Rivers initially relied on obsolete forecasts made in 1977 but

88 Ibid.

89 Ibid., page 9.

90 Ibid.

91 Brubaker's Prefiled Testimony, pages 11 and 12.

92 Thorpe Rebuttal Testimony, page 14.

93 Ibid.

then changed its emphasis to industrial demand after experiencing rapid erosion of its rural demand in early 1980. This included 95 MW for a fourth potline to be added by ARCO (predecessor of Alcan) but not yet under contractual agreement, 110 MW in synthetic fuels load in 1985, plus an unidentified potential load of 180 MW in 1985 for a total of 385 MW. Dr. Pifer concluded that such reliance on potentially large but uncommitted industrial loads was imprudent.⁹⁴ Dr. Pifer's analysis led him to conclude that all of Big Rivers' Wilson investment should be excluded from rates.

Mr. Thorpe testified that while the 1980 Power Requirements Study did include the expansion by ARCO, it did not contain any allowances for the synthetic fuel loads. He further stated that in 1981 if the largest unit was off-line, the combustion turbine was running, and 40 MW of SEPA power was purchased, the system could serve a load of 1126 MW.⁹⁵ He stated that this would have been about 45 MW short of the expected load of 1170 MW in 1984, when Jackson Purchase Electric Cooperative was to be added to the system and about 200 MW short of that needed in 1987 with the ARCO expansion.⁹⁶ These factors led Big Rivers to continue with the construction of the Wilson plant.

The Commission concludes that the evidence in this case does not clearly demonstrate that Big Rivers was imprudent in building

⁹⁴ Pifer Supplemental Prefiled Testimony on Prudence Issues, pages 43, 45, and 48.

⁹⁵ Southeastern Power Administration.

⁹⁶ Thorpe Rebuttal Testimony, pages 21-22.

Wilson. Like many utilities around the country, Big Rivers experienced an unanticipated flattening of its load growth. Coupled with that was a drastic decline in the fortunes of its major customers, the aluminum companies. Although the outcome of Big Rivers' decisions on Wilson has been difficult, the decisions themselves under the circumstances at the times they were made cannot be said to be clearly imprudent.

Used and Useful

A major issue in this rate case is whether the capacity of Wilson is needed on the Big Rivers system. The issue of the need for Wilson has been extensively addressed by all parties on both an engineering and economic basis. Basically, the intervenors' position is that the Commission is bound to employ the used and useful standard to determine whether the Wilson facilities are needed on Big Rivers' system and should be included in rate base for rate-making purposes. On the other hand, Big Rivers argues that undue reliance should not be placed on the used and useful standard because the Commission is obligated by statute to establish rates that are fair, just, and reasonable. The Commission is of the opinion that it is under no statutory obligation to apply a used and useful standard exclusively, or any other single, rigid standard.

KRS 278.290(1) provides that:

[T]he commission may ascertain and fix the value of the whole or any part of the property of any utility in so far as the value is material to the exercise of the jurisdiction of the commission, and may make revaluations from time to time and ascertain the value of all new construction, extensions and additions to the property of the utility.

In determining the value of a utility's property, this statute grants the Commission significantly more latitude than is available to those commissions that are constrained by a statutorily mandated used and useful criteria. The establishment of fair, just, and reasonable rates involves a balancing of utility and ratepayer interests. After balancing these interests, the Commission may conclude in a given case that rates should be based upon prudent investments even where facilities are cancelled prior to completion of construction. On the other hand, in considering the need for facilities on an economic basis, the Commission may decide that it is not in the customers' interest to pay rates that include the cost of unneeded facilities.

The controlling statutory standard for the establishment of utility rates is set forth in KRS 278.030(1): "Every utility may demand, collect and receive fair, just and reasonable rates for the services rendered or to be rendered by it to any person." A relevant Kentucky decision on valuing utility facilities is Fern Lake Co. v. Public Service Commission, Ky., 357 S.W.2d 701 (1962).

In Fern Lake, the Commission refused to permit a water utility, Kentucky Water Service Co., to increase the booked original cost of its water facilities despite its claim that the facilities had been intentionally undervalued as a convenience and conservative accounting practice. The Commission upheld the use of the book value on finding that the water facilities were substantially in excess of that needed to render service and, consequently, the lower book value accounted for this excess.

In affirming the Commission's decision, the Kentucky Court of Appeals held that:

[T]here was also evidence that since this water system was designed to serve an expected population far greater than the number of customers it has ever had, its facilities are far in excess of those needed; and hence the excess facilities are not used or useful so as to be a proper factor in establishing a rate base.... Furthermore, as a matter of law, we believe the Commission properly refused to include the cost of over-adequate facilities in the rate base. Fern Lake at 704-705.

Of significant note is the Court's statement that "the excess facilities are not used or useful." (Emphasis added.) While this language has led Big Rivers to argue that facilities can only be excluded from rate base if found to be neither used nor useful, such an argument is inconsistent with the totality of the Court's decision to focus on the adequacy and need for facilities.

In determining the need for facilities, such as an electric generating plant, the Commission must consider not only whether it is used and useful, but also the need for improved reliability, the system's load characteristics, the potential for growth of both system load and load factor, and other relevant economic and engineering factors. In establishing rates that are fair, just, and reasonable, the Commission must (1) determine the appropriate level of operating expenses; (2) fix a value on the utility's property; and (3) establish a rate of return for the rate base to produce a fair return on the investment of an investor-owned utility or establish a times interest earned ratio to allow the payment of interest and principle by a cooperative utility. The rate of return/times interest earned ratio is directly related to

the rate base determined. As the Court stated in Commonwealth ex re. Hancock v. South Central Bell, Ky., 528 S.W.2d 659, 662, (1975), "[T]he reasonableness of the rate of return cannot be decided in isolation from the rate base to which the rate of return will be applied, because the reasonableness of the rate of return will vary in accordance with the method or formula employed in fixing the rate base." (Emphasis in original.)

Rate base and debt service coverage for a cooperative utility must be determined by applying the same standards applicable to investor-owned utilities. Cooperatives, organized under KRS Chapter 279, "shall be subject to the general supervision of the Energy Regulatory Commission [predecessor of the Public Service Commission] and shall be subject to all the provisions of KRS 278.010 to 278.410(1)." KRS 279.210(1). A cooperative's system is defined as consisting of "any plant, works, facilities and properties...used or useful in the generation, production, transmission or distribution of electric energy." KRS 279.010(8). In balancing the equities to determine just and reasonable rates, the used and useful standard must be applied to cooperatives in the same manner as it is applied to investor-owned utilities.

In examining the results of the negotiations on a revised workout plan, the Commission will be guided by an evaluation of what is fair, just, and reasonable for Big Rivers, its customers, and its creditors. We do not believe that the statutes or the court in Fern Lake have shackled us to a mechanical application of the used and useful standard. We must carry out a complex balancing of equities and allocation of risk.

Reliability

The extensive debate over whether the Wilson unit is essential to the reliability of the Big Rivers' system starkly illustrates the fact that this case involves considerations other than a mechanical application of the used and useful test. We do not at this point have to accept the simple chain of logic presented by the parties which would follow from a determination with respect to reliability. Rather, the Commission is seeking a solution that would fairly balance the interests of all parties. Since we have found the proposed workout plan unreasonable and unacceptable, we have not had to settle the argument over the parameters of reliability. However, the issue of reliability as it relates to the used and useful concept remains before the Commission in its investigation of Big Rivers' rates. Thus, if the participants do not arrive at an acceptable agreement, the Commission will further evaluate the evidence on this issue.

Certificate of Convenience and Necessity

The Commission granted Big Rivers a certificate of convenience and necessity to construct Wilson on June 17, 1980, in Case No. 7557. Relying on that certificate, Big Rivers moved to strike portions of the testimony filed by NSA and Alcan on the grounds that the testimony was a collateral attack on the certificate. NSA and Alcan responded by stating that the testimony was not offered for purposes of rehearing or revoking the certificate but to address Big Rivers' prudence in planning and constructing the Wilson facilities. These prudence issues relate to whether Wilson should now be included in rate base. By

Order entered November 25, 1986, the Commission denied the motion to strike based on the findings that testimony addressing Big Rivers' prudence in planning and construction of Wilson was highly relevant to the fundamental issue of whether Wilson should be included in Big Rivers' rate base.

Big Rivers has continued to argue that the Commission's issuance in 1980 of a certificate to construct Wilson now bars any prudence review of Big Rivers' planning and construction decisions prior to 1980. The Commission does not intend to revoke the certificate in this rate case. In carrying out its statutory duty to value Big Rivers' property for rate-making purposes, the Commission must review and weigh all evidence surrounding Big Rivers' decision to construct Wilson.

Other Issues

Testimony and evidence which suggested that Big Rivers should give serious consideration to the option of filing bankruptcy to alleviate its financial problems was presented to the Commission. The Commission does not see bankruptcy as a preferable option for Big Rivers. Bankruptcy would prolong the corrosive uncertainty in the Big Rivers service territory. It could prove unfortunate for both customers and creditors.

Considerable evidence and testimony was presented concerning the proposed rate design in this case. The controversial point was the application of a ratchet demand provision in Big Rivers' tariff. Since no increase in revenue has been granted in this case, there is no reason to modify Big Rivers' tariffs at this

time. However, this issue remains before the Commission in its further investigation of Big Rivers' rates.

FURTHER PROCEEDINGS

The Commission is of the opinion that the serious financial problems now facing Big Rivers must be resolved quickly. The fate of Big Rivers, the aluminum smelters, and the economy of Western Kentucky cannot be left in doubt. The gravity of this situation demands that extraordinary steps be taken by the Commission to effectuate a fair solution.

Based on the decision herein to reject the workout plan and require Big Rivers to renegotiate with its creditors, the Commission will initiate a further proceeding to review the revised workout plan to be submitted pursuant to the provisions of this Order. A docket will be established for this purpose simultaneously with the issuance of this Order. In that docket the Commission will have before it all the issues in this case but not finally decided. We will consider these issues in the context of a revised workout plan, or, in the event an acceptable revision is not submitted, the Commission will make definitive determinations with respect to these issues.

Also to be considered will be the flexible power rates to be negotiated by Big Rivers with NSA and Alcan. The parties need to be aware during this negotiating process that should they be unable to resolve the rate issues surrounding Wilson and the smelters' economic viability, the Commission will move rapidly in the new docket to adjudicate those issues and establish fair, just, and reasonable rates for Big Rivers.

The Commission recognizes that the prior negotiations between Big Rivers and its creditors were protracted. However, there must now be an intensive effort among all participants to work together and expend their best efforts. The negotiations must proceed expeditiously, and the Commission will be available to assist in the process.

The Order initiating the new proceeding will provide that:

1. A revised workout plan and flexible power rates for NSA and Alcan should be submitted no later than July 17, 1987;
2. A hearing will be held on July 28, 1987, for the purpose of receiving testimony and cross-examination concerning the revised workout plan and the flexible rates;
3. The record of evidence in this rate case will be incorporated by reference in the new docket and all parties in the rate case will be designated parties therein.

GUIDELINES FOR REVISED WORKOUT PLAN

The Big Rivers power system is a valuable resource to the citizens of Western Kentucky and the Commission is looking for a reasonable, workable, long-term solution to Big Rivers' problems. In this Order the Commission has asserted its statutory right to review and approve a revised workout plan. The overall goal of the revised workout plan should be to stabilize the Big Rivers service area and provide for economic growth to diversify Big Rivers' load. The plan must offer an equitable balance among all interests. Any acceptable revised workout plan must seriously consider the following guidelines.

1. It is the opinion of the Commission that a good starting point for negotiation is the Sunflower Electric Cooperative Debt Restructure Plan. Recognizing the disturbing lack of load diversity and Big Rivers' dependence upon a sluggish aluminum industry, provisions similar to the Sunflower Plan which are not contingent upon an immediate rate increase and guaranteed full repayment of debt are desirable.

2. The immediate and primary source for debt service is off-system sales. Therefore, an agreement on off-system sales should be used in calculating any schedule of debt repayment. Big Rivers' ratepayers should not have unlimited responsibility for the payment of Big Rivers' debt. Furthermore, they should not be required to provide all the revenues required to offset shortfalls arising from insufficient off-system sales.

3. The interests of all affected parties must be considered: rural consumers, industrial customers and creditors. Big Rivers should meet with the creditors to negotiate a revised workout plan. Big Rivers and the aluminum companies should negotiate a flexible rate plan that recognizes the cyclical nature of the industry and the revenue requirements of the utility. Big Rivers, the Attorney General, and other interested parties should meet to discuss the negotiation and determine how the interests of customers other than NSA and Alcan can best be protected.

4. While the Commission expects and the public interest requires that all participants negotiate expeditiously and in good faith, the Commission will make the ultimate decision as to a reasonable long-term solution and no participant will have a veto.

The Commission wishes to see the results of negotiations within the time frame established herein.

5. The payment of Big Rivers' obligations to its creditors should take into consideration longer terms, reduced interest rates, deferral of principal and interest payments, preferred stock options, payments tied to off-system sales, and reduction of principal.

6. Consideration should be given to sale or disposal of Wilson to another entity or through establishment of a generating subsidiary as a possible long-term solution.

7. The plan should include well documented projections of system and off-system sales and cash flow over both the short and long term. Documentation should include a thorough explanation of all assumptions, reasonable specificity of targets, and detailed work papers supporting the long and short run cash flow projections.

8. A revised workout plan must contain much more affirmative support by REA of Big Rivers' efforts to achieve off-system sales. The current workout plan states only that "the REA will not unreasonably withhold its consent to power sales agreements proposed by BREC [Big Rivers] or to "non-disturbance" provisions with power purchasers in appropriate cases."

9. Priority of disbursements with regard to principal and interest should be clearly established.

10. Big Rivers is currently involved in litigation with REA and the Justice Department, Alcan, and NSA. The revised workout plan should include a settlement of all outstanding litigation.

SUMMARY OF FINDINGS

Based on the evidence of record and being advised, the Commission is of the opinion and hereby finds that:

1. The workout plan has a direct and immediate impact on Big Rivers' financial stability, thus rendering the workout plan subject to the jurisdiction of the Commission.

2. The workout plan will not provide for a workable, long-term solution to Big Rivers' financial problems and the workout plan should be denied.

3. The rates proposed by Big Rivers pursuant to the workout plan are unfair, unjust, and unreasonable and should be denied.

4. Big Rivers' expenditure of funds to complete Wilson was within management's discretion and that aspect of NSA's complaint should be denied. The issue of the allocation of off-system sales remains before the Commission in its investigation of Big Rivers' rates.

5. The Commission's 1980 Order in Case No. 7557 granting Big Rivers a certificate of convenience and necessity to construct the D.B. Wilson Generating Station does not estop the Commission, in a rate-making proceeding, from reviewing all issues surrounding Big Rivers' prudence in planning and constructing Wilson and deciding if Wilson should be included in rate base.

6. The evidence of record is insufficient to support any findings that Big Rivers was clearly imprudent in its decision to build Wilson and complete it in 1984.

7. Big Rivers should negotiate a revised workout plan with its creditors and negotiate flexible power rate schedules with NSA

and Alcan in accordance with the guidelines set forth in this Order. Big Rivers should discuss with the Attorney General and other interested parties how the interests of customers other than NSA and Alcan can best be protected.

8. A further proceeding should be initiated immediately to review the reasonableness of Big Rivers wholesale power rates and the results of Big Rivers' negotiations with its creditors and with NSA and Alcan. All issues not finally decided herein will be before the Commission in the further proceeding; the evidence of record herein should be incorporated by reference in the further proceeding; and all parties herein should be designated as parties in the further proceeding.

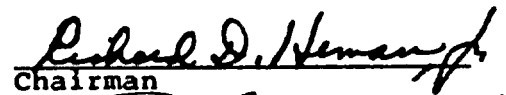
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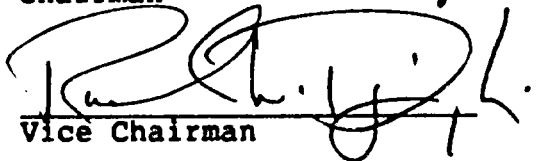
IT IS THEREFORE ORDERED that:

1. The rates proposed by Big Rivers be and they hereby are denied and Big Rivers shall continue to charge the rates set forth in its existing tariffs until further Order of the Commission.
2. The aspect of NSA's complaint alleging the diversion of funds for the completion of Wilson be and it hereby is denied.
3. Big Rivers' workout plan be and it hereby is rejected.
4. Big Rivers shall negotiate a revised workout plan with its creditors and negotiate flexible power rate schedules with NSA and Alcan in accordance with the guidelines set forth in this Order.
5. An investigative proceeding shall be initiated for the purposes set forth in Finding No. 8, above.

Done at Frankfort, Kentucky, this 17th day of March, 1987.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Executive Director